No. 88-1232

Supreme Court, U.S.
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In The Supreme Court of the United States
October Term, 1988

CLYDE W. ENGLE and LIBCO CORPORATION,

Cross-Petitioners,

v.

ESTATE OF GEORGE JOHNSON, ELEANOR MADSEN, CARMEN COLON, CASIMIRA MACIAS, SOLEDAD FREGOSO, MANUEL COLON, HILDA VALDES, CARMEN REGALADO, AMERICA SUAREZ, FERDINAND KANGISER, MARIA ROMERO, RAFAEL MENDOZA, JOSE LUIZ CORONA, HERIBERTO PIZZARO, RAMON GONZALAS and GUILLERMINA OLIVARES, for themselves and all participants in the Reliable Profit Sharing Plan Trust except CHARLES W. LEIGH and ERVIN F. DUSEK, the Plaintiffs,

Cross-Respondents.

CROSS-PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

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QUESTIONS PRESENTED

1. WHETHER THE SEVENTH CIRCUIT COURT OF APPEALS PROPERLY HELD TWO FIDUCIARIES RETROACTIVELY LIABLE IN 1988, FOR FAILURE TO SUPERVISE INVESTMENTS MADE BY PROFIT SHARING PLAN ADMINISTRATORS IN 1977 AND 1978, BASED ON A CASE OF FIRST IMPRESSION UNDER THE EMPLOYEE RETIREMENT SECURITY ACT OF 1974, 29 U.S.C. §1001-1461 ("ERISA"), HANDED DOWN IN 1984.

2. WHETHER THE SEVENTH CIRCUIT COURT OF APPEALS ERRED IN FAILING TO TREAT THE PROFIT SHARING PLAN'S COMMON STOCK INVESTMENTS AS A "PORTFOLIO" FOR PURPOSES OF DETERMINING DAMAGES UNDER ERISA.

LIST OF PARTIES

A list of all parties to the proceeding in the court whose judgment is sought to be reviewed is as follows:

Plaintiffs in the trial court were Charles W. Leigh and Ervin F. Dusek. They were not parties to the appeal to the Seventh Circuit at the time the Seventh Circuit rendered its opinion and judgment.

Intervening Plaintiffs are the Cross-Respondents to this Cross-Petition.

Cross-Petitioners Clyde W. Engle and Libco Corporation were defendants in the trial court. The following information is provided in accordance with Supreme Court Rule 28.1. Libco Corporation has no parent corporations. Publicly traded subsidiaries of Libco Corporation are: Hickory Furniture Company; Wisconsin Real Estate Investment Trust; Indiana Financial Investors, Inc.; NRG Incorporated; and Acton Corporation.

Nathan H Dardick, Ronald K. Zuckerman and National Boulevard Bank of Chicago were defendants in the trial court. They are Respondents to the petition for writ of certiorari filed by the Intervening Plaintiffs. They are not parties to this cross-petition.

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Cross-Respondents.

CROSS-PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

Cross-Petitioners Clyde W. Engle and Libco Corporation respectfully cross-petition for a writ of certiorari to review the judgment and opinion of the United States Court of Appeals for the Seventh Circuit, entered in the above titled proceedings on September 21, 1988, as amended September 30, 1988.

The petition for a writ of certiorari filed by the Intervening Plaintiffs, No. 88-1066, was received by the Cross-Petitioners on December 23, 1988. The petition was docketed by this Court as of December 20, 1988.

OPINIONS BELOW

The opinion of the Court of Appeals for the Seventh Circuit for which this cross-petition is filed is reported at 858 F.2d 361 (7th Cir. 1988) ("Leigh II"), and appears in the Petitioners' Appendix at pages 1a-20a. All refences in this cross-petition to the Appendix refers to the Appendix filed by the Petitioners in Case No. 88-1066. The judgment of the Court of Appeals for the Seventh Circuit appears in the Petitioners' Appendix at page 164a. The district court's Findings of Fact and Conclusions of Law is reported at 669 F.Supp. 1390 (N.D. Ill. 1987), and appears in the Petitioners' Appendix at pages 21a-76a. The district court's judgment dated August 27, 1987, appears in the Petitioners' Appendix at pages 77a-78a. The first opinion by the Court of Appeals for the Seventh Circuit is reported at 727 F.2d 113 (7th Cir. 1984) ("Leigh I"), and appears in the Petitioners' Appendix at pages 95a-147c.

JURISDICTION

Federal jurisdiction over this action exists pursuant to 29 U.S.C. §1132.

The district court's judgment was entered on August 27, 1987. The opinion of the Court of Appeals for the Seventh Circuit was handed down on September 21, 1988, and amended on September 30, 1988. The judgment of the Court of Appeals for the Seventh Circuit was entered on September 21, 1988. No petition for rehearing was sought.

This cross-petition is filed pursuant to Rule 19.5 of the Supreme Court Rules. The petition for writ of certiorari was received by counsel for the cross-petitioners on December 23, 1988.

The jurisdiction of this Court to review the judgment of the Seventh Circuit is invoked under 28 U.S.C. §1254(1).

STATUTES INVOLVED

The following statutes are involved in this cross-petition:

29 U.S.C. § 1104 a(1). Fiduciary duties

(a)(1) Subject to sections 1103(c) and (d), 1342, and 1344 of this title, a fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and—

(A) for the exclusive purpose of:

(i) providing benefits to participants and their beneficiaries; and

(ii) defraying reasonable expenses of administering the plan;

(B) with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims;

(C) by diversifying the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so; and

(D) in accordance with the documents and instruments governing the plan insofar as such documents and instruments are consistent with the provisions of this subchapter.

29 U.S.C. § 1105. Liability for breach of co-fiduciary

Circumstances giving rise to liability

(a) In addition to any liability which he may have under any other provision of this part, a fiduciary with respect to a plan shall be liable for a breach of fiduciary responsibility of another fiduciary with respect to the same plan in the following circumstances:

(1) if he participates knowingly in, or knowingly undertakes to conceal, an act or omission of such other fiduciary, knowing such act or omission is a breach;

(2) if, by his failure to comply with section 1104(a)(1) of this title in the administration of his specific responsibilities which give rise to his status as a fiduciary, he has enabled such other fiduciary to commit a breach; or

(3) if he has knowledge of a breach by such other fiduciary, unless he makes reasonable efforts under the circumstances to remedy the breach.

29 U.S.C. § 1105 (c)

Allocation of fiduciary responsibility; designated persons to carry out fiduciary responsibilities

(c)(1) The instrument under which a plan is maintained may expressly provide for procedures (A) for allocating fiduciary responsibilities (other than trustee responsibilities) among named fiduciaries, and (B) for named fiduciaries to designate persons other than named fiduciaries to carry out fiduciary responsibilities (other than trustee responsibilities) under the plan.

(2) If a plan expressly provides for a procedure described in paragraph (1), and pursuant to such procedure any fiduciary responsibility of a named fiduciary is allocated to any person, or a person is designated to carry out any such responsibility, then such named fiduciary shall not be liable for an act or omission of such person in carrying out such responsibility except to the extent that—

(A) the named fiduciary violated section 1104(a)(1) of this title—

(i) with respect to such allocation or designation,

(ii) with respect to the establishment or implementation of the procedure under paragraph (1), or

(iii) in continuing the allocation or designation; or

(B) the named fiduciary would otherwise be liable in accordance with subsection (a) of this section.

(3) For purposes of this subsection, the term "trustee responsibility" means any responsibility provided in the plan's trust instrument (if any) to manage or control the assets of the

plan, other than a power under the trust instrument of a named fiduciary to appoint an investment manager in accordance with section 1102(c)(3) of this title.

29 U.S.C. § 1108 (c)(3)

Fiduciary benefits and compensation not prohibited by section 1106

(c) Nothing in section 1106 of this title shall be construed to prohibit any fiduciary from—

* * *

(3) serving as a fiduciary in addition to being an officer, employee, agent, or other representative of a party in interest.

29 U.S.C. § 1109

Liability for breach of fiduciary duty

(a) Any person who is a fiduciary with respect to a plan who breaches any of the responsibilities, obligations, or duties imposed upon fiduciaries by this subchapter shall be personally liable to make good to such plan any losses to the plan resulting from each such breach, and to restore to such plan any profits of such fiduciary which have been made through use of assets of the plan by the fiduciary, and shall be subject to such other equitable or remedial relief as the court may deem appropriate, including removal of such fiduciary. A fiduciary may also be removed for a violation of section 1111 of this title.

(b) No fiduciary shall be liable with respect to a breach of fiduciary duty under this subchapter if such breach was committed before he became a fiduciary or after he ceased to be a fiduciary.

STATEMENT OF THE CASE

A. The Parties.

Cross-petitioner Libco Corporation ("Libco") purchased Reliable Manufacturing Corporation ("Reliable") on April 5, 1977. Cross-petitioner Clyde W. Engle ("Engle") is an officer and director of Libco. After Libco purchased Reliable, Engle became one of three directors at Reliable. The Reliable board of directors appointed Nathan H Dardick and Ronald K. Zuckerman to be administrators of the Reliable Profit Sharing Plan (the "Plan").

Cross-respondents are former employees of Reliable, and are beneficiaries of the Plan.

B. The Investment of Plan Assets.

Dardick and Zuckerman became Plan Administrators and assumed responsibility for management of Plan assets on September 15, 1977. Dardick, an attorney, was serving as general counsel to Libco and Telco Marketing Services, Inc. ("Telco"). Libco is the majority shareholder of Telco. Zuckerman, an experienced businessman with an MBA from the University of Chicago, was a director of both Libco and Reliable and was Reliable's chief executive officer. Neither Dardick nor Zuckerman received compensation as Trust Administrators.

After their appointment, Dardick and Zuckerman retained counsel to bring the Plan into conformity with ERISA. They also retained the accounting firm of Berman and Berman to serve as plan accountants and retained Charles Newbill ("Newbill"), a financial analyst and investment advisor, to recommend investments for the Plan's portfolio.

At the time Dardick and Zuckerman assumed responsibility for the Plan, it was invested 100% in money market funds. Counsel advised Dardick and Zuckerman that ERISA required the administrators to diversify Plan investments. Dardick asked Newbill to recommend investments. After careful analysis, Newbill recommended the purchase of the common stock of Berkeley Bio-Medical, Inc. ("Berkeley"), Outdoor Sports Industries ("OSI"), and Hickory Furniture Company ("Hickory").

Between March 17 and March 31, 1978, the Reliable Trust purchased 15,800 shares of Berkeley; 12,400 shares of OSI; and 8,000 shares of Hickory. The Trust purchased another 100 shares of OSI on April 11, 1978, and 4,000 shares of Hickory on June 9, 1978. The Trust's total investment in Berkeley was $71,580.53; in OSI $77,736.83; and in Hickory $72,433.21. All of the purchases were made on the open market through stock brokers. These common stock investments represented approximately 30% of the Plan's investment portfolio. The remaining assets were invested in money market type investments.

Engle and Libco did not ask the Administrators to make these stock purchases and only learned of them after the purchases were substantially completed. At that point, Engle and Libco did not recommend the sale of the stock, because they considered the purchases to be good investments for the Plan.

Engle had independently consulted with investment adviser Newbill and personally studied Berkeley, OSI and Hickory. Engle had concluded that each of the companies were sound and prudent investments. Engle also knew that the Harris Bank owned stock in Berkeley in its role as Trustee for other pension and profit sharing plans. In exercising his fiduciary duty as a member of Telco's Board, Engle agreed with the Telco Board's decision to invest Telco's funds in Berkeley, OSI and Hickory. At all times, the Plan's investments were kept separate and apart from investments being made by Engle and companies related to him.

C. Stock Investments By Engle Related Entities.

During the first Quarter of 1978, when the Reliable Trust made its investments in common stock, Libco had assets of approximately $48 million, and Engle had a personal net worth of almost $5 million.

1. Investments in Berkeley.

By March 31, 1978, the Reliable Trust had completed the purchase of its 15,800 shares in Berkeley at a total investment of $71,580.53. As of March 31, 1978, Engle and related entities, not including the Trust, owned 96,520 Berkeley shares purchased for approximately $476,979.00. Between March 31 and August

18, 1978, Telco and Telvest, Inc. ("Telvest"), a subsidiary of Telco, purchased 146,900 Berkeley shares on the open market for approximately $753,409; and purchased at cost the 63,000 shares belonging to Engle for approximately $318,810.00. On August 18, 1978, Engle personally owned 120 Berkeley shares and Libco owned no Berkeley shares.

Telco, Libco and Engle filed a Schedule 13D dated April 29, 1978. The Schedule 13D did not include the Reliable Trust as a reporting person, but included the Trust's 15,800 shares, or .65% of the outstanding Berkeley shares, in calculating the shares disclosed by the reporting persons. The inclusion of the Trust's shares in the Schedule 13D caused them to publicly disclose their holdings earlier than otherwise would have been necessary.

On April 7, 1978, Engle sued Cooper Laboratories to enjoin Cooper's acquisition of a Berkeley subsidiary. On June 21, 1978, Telco also sued Berkeley and Cooper. The Reliable Trust was not a party to either lawsuit and incurred no expense in connection with the litigation.

On August 18, 1978, the lawsuits were settled and Cooper argreed to buy the Berkeley shares owned by all plaintiffs for $7.50 per share, although the market price was then between $5 and $6 per share. Cooper did not insist on purchasing the Trust's stock as part of the settlement, but did so only at Dardick's request. Inclusion of the Trust shares benefited the Trust by allowing it to sell its Berkeley shares at a substantial premium.

All proceeds from the sale of the Trust's Berkeley shares, $118,500.00, which includes at 66% profit, were received by the Trust. The Trust's assets were at all times kept under the physical control of the Plan Trustee, the Harris Bank, and later, the successor trustee, the National Boulevard Bank.

2. Investments in OSI.

On April 11, 1978, the Reliable Trust completed the purchase of the last of its 12,500 OSI shares at a total investment of $77,736.83. At that time, Engle owned 3,500 shares, and GSC Enterprises owned 8,100 shares, at a total investment of approximately $83,870.00. Between April 11, 1978, and May 4,

1979, Telco and Telvest purchased the shares of Engle and GSC at cost and purchased an additional 290,100 shares for approximately $2,561,152.00. After May 5, 1978, neither Engle nor Libco owned any OSI stock.

Telco and Libco filed a Schedule 13D dated May 10, 1978, regarding purchases of OSI stock. The Schedule 13D identified the Trust's ownership of 12,500 shares or .87% of the outstanding OSI stock, but stated that "Libco expressly disclaimed any beneficial interests in the assets of Reliable Trust." Because the 13D included the Trust's shares in calculating the required filing date, the Trust's OSI stock caused Telco and Libco to disclose their OSI holdings earlier than the filing requirements would have otherwise required.

In early 1979, Telco and Telvest sought to obtain control of OSI through two tender offers and a proxy fight. The Trust was not a party to the tender offers or proxy fight and incurred no costs in connection therewith. On June 1, 1979, Brown Group, Inc. entered the control contest as a "white knight" and made a tender offer for all outstanding OSI shares at $15 per share, provided that not less than 51% of the outstanding OSI shares were tendered. On June 26, 1979, the Reliable Trust sold its OSI shares to the Brown Group for a 141% profit to the Trust of $109,763.17. At the same time, Telco and Telvest tendered their shares to the Brown Group. All proceeds from the sale of the Trust's shares, $187,500, were received by the Trust.

3. Investments in Hickory.

On March 22, 1978, when the Reliable Trust bought 8,000 shares of Hickory, Libco already owned a total of 50,400 Hickory shares.

Telco and Libco filed a Schedule 13D dated May 1, 1978. On May 25, 1978, Telco and Libco amended the original 13D, pursuant to the SEC's beneficial ownership disclosure rules to disclose the Reliable Trust's 8,000 Hickory shares and the fact that Libco disclaimed any beneficial interest in the Trust's Assets.

Between March 22 and June 7, 1978, Telco purchased an additional 109,800 Hickory shares. On June 9, 1978, the Reliable Trust purchased an additional 4,000 shares. From June 9, 1978 to March 19, 1979, Telco and Telvest purchased 217,960 shares

of Hickory stock. On March 19, 1979, the Trust sold all 12,000 of its Hickory shares for $75,000, which included a 4% profit of $2,566.79. All proceeds from the sale of the Trust's shares were received by the Trust.

Telco and Telvest continued to purchase Hickory stock, and in late October, 1980, owned more than 50% of the company's outstanding shares.

PROCEEDINGS BELOW

Leigh I. Judge George N. Leighton originally tried this case in 1982, and entered judgment for defendants in all respects. (App. 148a). On appeal, the Seventh Circuit vacated the judgment and remanded the case for further proceedings. *Leigh v. Engle,* 727 F.2d 113 (7th Cir. 1984) (App. 95a).

The Seventh Circuit reversed Judge Leighton's finding that Dardick and Zuckerman did not breach their fiduciary duties when they invested Trust Assets in Berkeley, OSI and Hickory. The Court held that Dardick and Zuckerman breached their fiduciary duties because they invested Trust Assets where a potential conflict of interest existed. The Seventh Circuit held that Engle and Libco were fiduciaries with respect to the selection and retention of Plan Administrators, and remanded for determination of whether the fiduciary duties of Engle and Libco extended to the Trust's investments in Berkeley, OSI and Hickory, and if so, whether they breach those fiduciary duties.

Leigh II. Judge Brian Barnett Duff retried the case in 1986, and on August 27, 1987, entered his Findings of Fact and Conclusions of Law ("Findings"). (App. 21a). On the issue of the liability of Engle and Libco for the Trust's investments in Berkeley, OSI and Hickory, Judge Duff concluded that both Engle and Libco breached their fiduciary duties by failing to properly monitor the actions of Dardick and Zuckerman. (App. 23a).

On the issue of damages, the district court refused to consider the three investments in Berkeley, Hickory and OSI as part of a common stock portfolio with an aggregate return of 72%. (App. 48a). Instead, the district court awarded $6704 in damages based on the 4% return on the Hickory investment. (App. 49a).

The Seventh Circuit affirmed the decision on September 21, 1988. (App. 1a).

REASONS FOR GRANTING THE WRIT

I. THE WRIT SHOULD BE GRANTED BECAUSE THE IMPOSITION OF RETROACTIVE LIABILITY UPON ENGLE AND LIBCO CONFLICTS WITH ESTABLISHED PRECEDENT OF THIS COURT.

A. The Lower Courts Imposed Retroactive Liability Upon Engle and Libco.

In *Leigh I,* Libco and Engle were held to be fiducaries under ERISA "to the extent that they performed fiduciary functions in selecting and retaining plan administrators." (App. 133a). ERISA ties fiduciary responsibilities to a person's actual authority and "the key language in the statutory definition is that a person is a fiduciary only to the extent he or she exercises control or authority over the plan." (App. 133a).

The case was remanded by the Seventh Circuit to the district court to decide whether "Engle and Libco fulfilled the duties of surveillance and oversight which stemmed from their power to select and retain the plan administrators." (App. 135b, n. 33). In *Leigh I,* the court held "plaintiffs have not shown that the district court clearly erred in finding that Engle and Libco did not exercise authority over the trust's investments in Berkeley, OSI and Hickory." Id. Specifically, the district court was asked to consider whether Libco and Engle acted reasonably and prudently in light of their knowledge of the trust's investments in Berkeley, Hickory and OSI. (App. 137a).

On remand, the district court concluded that Engle and Libco did not take reasonable action to ensure that Dardick and Zuckerman were fulfilling their fiduciary obligations because "Engle and Libco knew of, but chose to ignore, Dardick's and Zuckerman's pursuit of a speculative investment policy which risked the trust's assets while at a minimum creating the appearance of serving Engle's and Libco's own business interests." (App. 26a). The Court of Appeals affirmed.

The lower courts' conclusion is extremely harsh and rests upon an unsound factual and legal premise. The decision is unduly harsh because it singles out only one member of a board

of directors, Engle, for liability. The decision ignores the fact that at the time of the conduct complained of, 1978-9, *there was no case law or administrative guidelines to suggest that Dardick and Zuckerman had acted improperly,* and this case was pending before a judge who approved the action taken. (App. 148a). The decision rests upon an unsound factual premise because it erroneously assumes that Engle and Libco knew or believed the investments to be speculative or unlawful. The decision rests upon an unsound legal premise that boards of directors of public companies must overrule their plan administrators' investment decisions, even where the directors have no actual authority over those decisions, or else remove the administrators despite the clear language of 29 U.S.C. §1108(c)(3) which expressly authorizes a fiduciary to serve in a dual capacity.

29 U.S.C. §1108(c)(3) states that officers or directors and others do not have an inherent conflict of interests merely by acting as trustees. It states: "nothing in . . . this title shall be construed to prohibit any fiduciary from (3) serving as a fiduciary in addition to being an officer, employee, agent or other representative of a party in interest." Thus, the Reliable board of directors, including Engle, were perfectly justified in picking Dardick and Zuckerman as administrators.

The decision in *Leigh I,* that good faith investments by the administrators resulted in a breach of fiduciary duty, constituted new law under ERISA. The district court had found the conduct totally proper in the first trial. (App. 148a). It is unfair to hold Engle and Libco liable for their failure to know of this violation in 1977-1978, when it did not become a violation until *Leigh I* was handed down in 1984.

The type of transaction engaged in by the administrators finds approval in the legislative history. "In general, it is expected that a transaction will not be a prohibited transaction if the transaction is an ordinary 'blind' purchase or sale of securities through an exchange where neither buyer nor seller (nor the agent of either) knows the identity of the other party involved." House Conference Report No. 93-1280, 93rd Cong. 1st Session reprinted in 1974 U.S. Cong. Admin. News at p. 5087. Because the transactions were all open market purchases and sales, except for the sale of the Berkeley shares, there was no basis upon which

Libco and Engle could have expected that the investments by the plan administrators violated ERISA.

With the foregoing factors in mind, it is clear that neither Libco nor Engle could have had the requisite knowledge required to violate 29 U.S.C. §1105. The statute states:

> (a) *Circumstances giving rise to liability.* In addition to any liability which he may have under any other provision of this part, a fiduciary with respect to a plan shall be liable for a breach of fiduciary responsibility of another fiduciary with respect to the same plan in the following circumstances:
>
> > (1) if he *participates knowingly* in or *knowingly* undertakes to conceal an act or omission of such other fiduciary *knowing* such act or omission is a breach;
> >
> > (2) if by his failure to comply with Section 1104(a)(1) of this title in the administration of his specific responsibilities which give rise to his status as a fiduciary he has enabled such other fiduciary to commit a breach; or
> >
> > (3) if he has a *knowledge* of a breach by such other fiduciary, unless he makes reasonable efforts under the circumstances to remedy the breach.

Libco and Engle did not have the scienter required under this statute. The legislative history fully supports Engle and Libco's position. The legislative history states:

> "*Liability for breach of co-fiduciary responsibility in general.* — A fiduciary of a plan is to be liable for the breach of fiduciary responsibility by another fiduciary of the Plan if he knowingly participates in a breach of fiduciary duty committed by the other fiduciary. Under this rule, the fiduciary must know the other person is a fiduciary with respect to the Plan, must know that he participated in the act that constituted a breach *and must know that it was a breach.*
>
> In addition, a fiduciary is to be liable for the breach of fiduciary responsibility by another fiduciary of the Plan, if he knowingly undertakes to conceal a breach committed

> by the other. For the first fiduciary to be liable, he must know that the other is a fiduciary with regard to the Plan *and must know that it is a breach.*
>
> Also, if a fiduciary knows that another fiduciary of the Plan has committed a breach, *and the first fiduciary knows that this is a breach,* the first fiduciary must take reasonable steps under the circumstances to remedy the breach.
>
> A fiduciary also is to be liable for the loss caused by the breach of fiduciary responsibility by another fiduciary of the Plan if he enables the other fiduciary to commit a breach through his failure to exercise prudence in carrying out his specified responsibilities."

House Conference Report No. 93-1280, 93rd Cong. 1st Session, reprinted in 1974 U.S. Cong. Admin. News at 5080.

The scienter requirement is highly relevant because the original trial court held that the Administrators did not violate ERISA. It is both unfair and unreasonable to expect Libco and Engle to have greater knowledge of ERISA than did the original trial judge. ERISA was a new statute which was largely undefined by case law or administrative regulation as of 1978-1979, when the investments were made. There was no self-dealing. There was no actual conflict of interests. There was no intermingling of assets. Every penny of the profit sharing trust's investments was received by the Trust.

In *Leigh I,* the Court held that even though "In that general sense [ultimate maximization of stock values], the interests were not in actual conflict. However, because the plaintiffs have shown that the Trust Administrators clearly faced *potentially* conflicting interests and continued to exercise control over the plan assets in ways that directly benefited the Engle group, grave doubts arise concerning the administrators' loyalty." (App. 123a).

The only way to find liability against the administrators was the creation of new law finding liability. This is exactly what the Court of Appeals did in *Leigh I.* The closest other case discussing this principle, *Donovan v. Bierwirth,* 680 F.2d 263 (2nd Cir. 1982), cert. denied, 103 S.Ct. 488 (1982), was also decided years after the alleged breach of duty occurred. The Trust's

investments in Berkeley, Hickory and OSI had all been sold by 1979.

Because Libco and Engle had only supervisory authority, the lower courts improperly imposed liability upon them. They should not have been held liable for failing to supervise conduct in 1978-1979 which did not become unlawful until 1984.

B. Mr. Engle and Libco Properly Performed their Oversight Function.

The record clearly reflects an effort by Mr. Engle and the other two Reliable Manufacturing Corporation board members to perform their duties of surveillance and oversight.[1] At the time of the purchase of Reliable by Libco in 1977, the Plan was in disarray. The Plan had not as yet been brought into compliance with ERISA and the Plan investments were not diversified, 100% being invested in short term assets. (Engle Tr. 709-712*, Leigh Tr. 1169-1171, Meyer L-Tr. 598-602).

Mr. Engle testified that Mr. Dardick and Mr. Zuckerman were appointed administrators because of their competence to deal with the problems facing the Plan. (Tr. 709-710). The Reliable Board directed the administrators to see to it that the Plan was brought into compliance with ERISA, to hire the lawyers, accountants and other professionals necessary to properly document and administer the trust. (Tr. 711-712). The Plan documents placed the power to direct all investments in the hands of the administrators. DX VV par. 3*.

The Plan administrators followed through to correct the deficiencies. They hired outside counsel to draft and present a new plan to the Reliable Board for its adoption and approval

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[1] For purposes of this brief, the following system of references to the record is used:

PX = plaintiffs' trial exhibits; DX = defendants' trial exhibits; IX = Intervenors' trial exhibits; Tr. ____ = page reference to testimony before J. Duff; L-Tr. = page reference to testimony before Judge Leighton which was made part of the second trial; * = Included in Defendants' Joint Appendix which was filed in a separate document with defendants' briefs in the Seventh Circuit.

by the IRS in conformity with ERISA. (DX B, DX 606). They retained an accounting firm to prepare and file necessary returns and reports. The administrators consulted with the Trustee and an investment advisor regarding diversification and suitable investments for the Trust. (Dardick L-Tr. 817-822, Newbill L-Tr. 723-726). Within six months of the appointment of the new Plan administrators, the Board's goal of having a plan in conformity with ERISA and necessary professionals to assist the administrators had been accomplished.

In April, 1978, when Mr. Engle and Libco learned of the Plan's investments in Berkeley, Hickory and OSI, they were not aware of any conflict of interest or speculative investments. (Engle Tr. 793-794, 1217-1229*). Mr Engle, who had extensive investment experience, believed the Plan's investments in Berkeley, Hickory and OSI to be prudent for a profit sharing plan. (Tr. 1219-1229, 1828-1837*).

Mr. Engle had previously been employed in the Harris Bank Trust Department as a securities analyst to select fiduciary investments. He explained why he believed these investments to be prudent based on his extensive experience at the Harris Bank. (Tr. 1219-1229, 1828-1837*).

Thereafter, as a member of the board of Telco, a public company with 500-1000 shareholders, Mr. Engle and the other independent directors, acting in their fiduciary capacity, committed millions of dollars to these same investments. The minutes of the April 21, 1978, Telco Board meeting reflect that these companies were chosen as investment candidates because they are "good solid companies in which investments can be made at a price which is less than the tangible net worth per share. This selection policy should minimize the risk to the Company in such investments." DX 621, p. 3*. Under these circumstances, it was error to conclude that Mr. Engle and the Libco board did not perform their duty of surveillance. There is no indication that they were aware of any conflict between the Trust and Telco's investment. The trust's assets were always kept separately by the National Boulevard Bank or Harris Bank, as trustee, and there were no purchases or sales of securities between the Trust and any person or entity connected with any defendant.

It is important to remember that this litigation was filed in September, 1978, after which time Mr. Engle and Libco looked to counsel and the district court to address the issues being raised. (Tr. 794*). It is unfair and unrealistic to expect Mr. Engle and Libco to have taken any separate action while the entire question of the propriety of the investments and request for removal of the Plan administrators was before the Court. On May 30, 1979, the district court denied a motion for appointment of a receiver, and on November 18, 1982, after a full trial, found no improper conduct on the part of the Plan administrators. (App. 148a). Neither Libco nor Mr. Engle should be held liable, some ten years later, for not having anticipated the contours of ERISA responsibility which were announced in *Leigh I* in 1984. There has been no finding that Mr. Engle or Libco ever caused those investments to have been made or that they did not have a reasonable understanding that they were prudent investments for the trust.

In announcing important principles regarding ERISA, individual corporate directors have been exposed to unwarranted liability. Directors will be reluctant to establish pension and profit sharing plans if they are exposed to unknown risks by the exercise of their reasonable business judgment. Mr. Engle's judgment that the Plan's investments in Berkeley, Hickory and OSI were prudent was the product of his extensive investment experience. This investment insight was later proven correct, both for the Plan and for Telco. On these facts, the lower courts clearly erred in concluding that Engle and Libco knew that the administrators were pursuing a speculative investment policy.

C. The Lower Courts' Decisions Conflict With at Least Two Decisions of this Court.

The Supreme Court has stated that a Court must weigh three factors to determine if it can apply a law prospectively only. The Court announced the test in *Chevron Oil v. Hudson*, 404 U.S. 296, 30 L.Ed.2d 296, 92 S.Ct. 349 (1971).

The Court laid down a three-part test:

> First, the decision to be applied nonretroactively must establish a new principle of law, either by overruling clear past precedent on which litigants may have relied, (cites omitted), or by deciding an issue of first impression whose resolution was not clearly foreshadowed. (cites omitted). Second, it has been stressed that "we must . . . weigh the merits and demerits in each case by looking to the prior history of the rule in question, its purpose and effect, and whether retrospective application will further or retard its operation." (cites omitted). Finally, we have weighed the inequity imposed by retroactive application for "where a decision of this Court could produce substantial inequitable results if applied retroactively, there is ample basis in our cases for avoiding the 'injustice or hardship' by a holding of non-retroactivity." (cites omitted), 404 U.S. at 306.

Looking at these factors, the Seventh Circuit erred in failing to apply the new law announced in *Leigh I* prospectively only.

Leigh I created new principles of law under ERISA. The Seventh Circuit widened the scope of liability to include situations involving "potential," and not actual, conflicts of interest.

The *Bierworth* and *Leigh I* decisions first announced that a trustee must seek independent investment counsel. Until those decisions, a member of the board of directors of Reliable who observes the administrators investing and earning a 72% return would have no reason to expect that those administrators violated ERISA. Nowhere in the legislative history or in the ERISA statute does it state that a party *must* retain independent investment counsel.

The second part of the Chevron test looks at whether retrospective application of the law will further or retard its operation on a case by case basis. In the case at bar, full relief is available without applying the law retroactively to Libco and Engle. Therefore, the application of *Leigh I* prospectively only does not in any way retard the operation of ERISA.

Finally, the third element of the test is the possibility of inequitable results if the Court applies the law retroactively. Engle and Libco face extreme hardship as a result of the decision in *Leigh II.* As Chairman of the Board of Bank of Lincolnwood, the decision in *Leigh II,* holding Engle to have breached his fiduciary duty, creates a major stigma that can affect him professionally and personally. Customers and other bankers may refuse to deal with someone who has been branded as having breached his fiduciary duty.

It is impossible to measure how many business relationships may be adversely affected. To inflict this kind of damage to Engle's and Libo's reputation based on their failure to supervise conduct in 1978-1979 which did not become illegal until 1984, constitutes a grossly "inequitable result."

Furthermore, this Court has specifically stated that new interpretations of pension laws are to have a prospective application. In *City of Los Angeles Dept. of Water and Power v. Manhart,* 435 U.S. 702, 720, 55 L.Ed.2d 657, 98 S.Ct. 1370 (1977), this Court applied an ERISA decision prospectively stating:

> [W]e must recognize that conscientious and intelligent administrators of pension funds, who did not have the benefit of the extensive briefs and arguments presented to us, may well have assumed that a program like the Department's was entirely lawful.

This Court noted that Congress was mindful of not applying ERISA retroactively and the importance of making "only gradual and *prospective* changes in the rules that govern pension plans." (Emphasis added). 435 U.S. at 721, n. 40.

The Seventh Circuit's decision disregards the holdings of this Court which require a prospective application of *Leigh I.* This manifest injustice against Engle and Libco should be rectified by the granting of the writ.

II. THE COURT OF APPEALS SHOULD HAVE CONSIDERED THE CHALLENGED INVESTMENTS AS A PORTFOLIO FOR PURPOSES OF COMPUTING DAMAGES.

This Court should grant the writ of certiorari to decide the important question of whether ERISA investments should be considered individually or as a portfolio. This question has enormous consequences for the billions of dollars of ERISA funds which are invested. If the Seventh Circuit's decision is not reversed, ERISA fiduciaries face the threat of liability for making one wrong investment decision out of hundreds, even though the investment portfolio as a whole performs properly.

In remanding this case, the Court of Appeals noted that "[t]here is no claim here that the Reliable Trust lost any money through the disputed investments" (App. 103a), and that "[i]t is clear that the trust lost no money in the challenged transactions" (App. 109a). The lower courts nonetheless found that the trust suffered opportunity losses of $6,704 on its Hickory investment (App. 49a), considering each of the challenged investments separately, and ignoring the almost $160,000 (72%) in total profits made by the Trust on those investments when viewed together. The lower court's finding of losses was legally and factually erroneous.

In finding a loss of $6704, the lower courts evaluated defendants' investment decisions under the traditional prudent man rubric wherein "each investment is evaluated in isolation from the portfolio of which it is a part." Note, *Fiduciary Standards and the Prudent Man Rule Under the Employment Retirement Income Security Act of 1974*, 88 Harv. L. Rev. 960, 967 (1975) (hereinafter "Fiduciary Standards"). That analysis is inconsistent with modern principles of sound financial management and ERISA.

> A major thesis of investment management is the need to consider individual investments as components of an overall plan. Without limiting the range of investments covered, it is convenient to call individual investments *securities* and the totality the *portfolio*.

> Since it is rarely desirable to invest the entire funds of an individual or an institution in a single security, it is essential that every security be viewed in a portfolio context.

W. Sharpe, *Investments* at 119 (3d ed. 1985). These same principles are increasingly finding application in analysis of investment of trust assets generally. "[F]rom the beneficiary's standpoint what counts is the performance of the portfolio rather than the performance of its individual components . . . From the beneficiary's standpoint, the portfolio is the relevant security." Langbein and Posner, *The Revolution in Trust Investment Law,* 62 A.B.A.J. 887, 889-90 (1976).

Modern investment theory is appropriately applied in an ERISA context. *See Fiduciary Standards,* 88 Harv. L. Rev. at 973 ("the lessons of investment theory provide a suitable and practical approach to defining the standards of ERISA's general fiduciary provisions."). Under that theory and practice "the entire portfolio should be the frame of reference for the evaluation of substantive investment decisions." *Id.* Accordingly, regulations regarding investments duties of fiduciaries under ERISA require consideration of "the role the investment or investment course of action plays in that portion of the plan's investment duties." 29 C.F.R. §2550.404a-1(b). In discussing a fiduciary's obligation under trusts covered by ERISA, it has been observed that:

> In the case of such trusts as these the question of the amount of risk which may properly be taken by the trustee is somewhat different from that which is presented in the case of ordinary private trusts. The court may well lay greater influence on the portfolio as a whole as one of the factors in determining whether the trustee has acted prudently in making and retaining investments.

III A. Scott, The Law of Trusts, 1985 Supp. at 59 (3d ed. 1967 & 1985 Supp.).

Notwithstanding ERISA's apparent incorporation of modern investment portfolio theory, the lower courts declined to consider the Hickory investment as part of a portfolio with the other

challenged common stock investments for purposes of computing damages.

The Seventh Circuit recognized the validity of modern investment theory, but failed to apply it to the case at bar. Under that theory, the Hickory investment cannot be considered in isolation from the Berkeley and OSI transactions.

> Under portfolio investment theory, a fiduciary should not seek only those investments whose rate of return or level of risk is equivalent to that desired. Rather, he should structure a portfolio of risky investments so as to maximize the rate of return per unit of risk. By then dividing his assets between that portfolio and a portfolio of risk-free investments, the investor can reach his desired level of risk for the entire portfolio. This approach is the most efficient since for any overall level of risk selected, the portfolio will yield the maximum rate of return per unit of risk.
>
> In structuring the portfolio of risk investments, diversification is useful to reduce the level of risk associated with any rate of return by minimizing the degree to which the values of the portfolio investments covary. Studies have demonstrated, however, that after a rather limited amount of diversification, the resulting reduction in portfolio risk attributable to each additional security becomes negligible.

Fiduciary Standards, 88 Harv. L. Rev. at 971 (footnotes omitted). Consistent with these principles, ERISA requires that investments be diversified "so as to minimize the risk of large losses," unless such diversification is clearly imprudent. 29 U.S.C. §1104(a)(1)(C). Where diversification occurs, "[t]o consider the risk of each investment apart from the portfolio would therefore overstate the uncertainty associated with that portfolio." *Fiduciary Standards*, 88 Harv. L. Rev. at 970-71.

The Seventh Circuit in *Leigh II* recognized the wisdom of the portfolio theory stating (App. 13a):

> Given the fact that investment advisors generally follow a portfolio strategy of investment and that

> beneficiaries whose assets are being managed are concerned with the end result of that strategy, not with the return on a single element in the portfolio, it makes sense for courts to look at the whole portfolio to determine the investment strategy's success (cites omitted).

Despite this statement, the Seventh Circuit refused to apply the portfolio theory (App.13a).

In the present case, the administrators were required under ERISA to diversify trust investments, and as part of the diversification invested 30% of the trust's assets to purchase stock in Berkeley, Hickory and OSI. The remainder of the assets were invested in fixed income securities. The 72% return on the common stock portfolio outperformed all other comparable portfolios of common stock. Incorporating some element of risk into the trust portfolio is mandated by modern investment theory. *See Fiduciary Standards,* 88 Harv. L. Rev. at 973-74 n. 82 (cannot evaluate "riskiness of particular investment in isolation rather that as part of a portfolio whose objective is the maximization of return per unit of risk.") The risk was introduced by purchase of the three common stocks together, as part of a single investment course of action. App. 87a. ("the decision to use the fund's assets for the purchases, and the strategy used, was determined as a whole").

The lower courts should have examined the return on the investments in Berkeley, OSI and Hickory as a whole, and not the return on each investment individually. The Plan enjoyed an overall return on 72% on this risk portfolio, and thus suffered no losses on its stock investments. App. 103a, n. 9. Because the Court of Appeals failed to use the portfolio approach in evaluating the return on investment, this Court should issue its writ in order to clarify the proper standard to be applied under ERISA.

IV. CONCLUSION.

For the foregoing reasons, a writ of certiorari should issue to review the judgment and opinion of the Court of Appeals for the Seventh Circuit.

Respectfully submitted,

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